

# CPA

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# Client Bulletin

BUSINESS & TAX PLANNING IDEAS for OUR CLIENTS and FRIENDS

## Enjoy Real Tax Savings From Investment Property

Falling prices have created a buyer's market in housing. The same trends might encourage you to shop for a home that you can rent to tenants. Rents may firm as more would-be home buyers are denied mortgages and rent homes instead. What's more, tax breaks for real estate investors can make such ventures attractive.

### Sheltered cash flow

Owners of investment property are entitled to some non-cash deductions, such as depreciation. These deductions may help you avoid tax on any net rental income you receive.

To see how this might work, suppose that you buy a house that you rent for \$2,000 per month. That's \$24,000 per year. Also suppose that your expenses add up to \$19,000 per year. You would put \$5,000 into your pocket. However, you might have a \$9,000 depreciation deduction in this hypothetical example. Now you'd have a \$4,000 loss, for tax purposes. With a taxable loss, you'd owe no tax. Thus, your \$5,000 in cash flow will be tax free, sort of.

### Paying the price

Is this tax-free cash flow really tax free? Not exactly. Depreciation deductions lower your basis in the property. A lower basis, in turn, will increase your tax on an eventual sale. Fortunately, the tax on prior depreciation deductions is capped at 25%. Thus, you may defer tax normally owed at rates up to 35% and pay it years later at a 25% rate.

There is actually a way to avoid paying tax on the depreciation deductions you've taken. Under current law, assets such as real

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### Did You Know?

**Oil consumers are paying \$4 billion to \$5 billion more for crude oil every day than they did in 2002. More than \$2 trillion went into the coffers of oil companies and oil-producing nations in 2007.**

Source: Washington Post

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America Counts on CPAs

estate get a basis step-up to market value when they're left to heirs. Therefore, if you hold onto investment property until death, your heirs can sell the property for its current value and owe no capital gains tax. All the tax-free cash flow you received during your lifetime will never be taxed.



### Win from losing

In the example above, you wound up with a \$4,000 loss, for tax purposes. Such a loss might be deductible, depending on your adjusted gross income (AGI). Losses from rental properties are known as passive losses. If your AGI is no more than \$100,000, passive losses are deductible, up to \$25,000 per year.

Over \$100,000, this deduction is phased out. Say you own a rental property with a tax loss and your AGI is \$120,000. You are 40% of the way through the \$100,000-\$150,000 phaseout range, so your maximum passive loss deduction is 60% of \$25,000: \$15,000. If your AGI is \$150,000 or more, you generally cannot deduct passive losses.

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**Loss carry-overs**

If you have passive losses that you can't deduct right away, they may be carried forward to future years indefinitely. Those losses can be used to offset any taxable income you might have from rental properties. If you haven't used your passive losses by the time you sell the property, they will be deductible against your ordinary income in the year of sale. If you have a gain on the sale, favorable capital gains rates will apply.

**An active approach**

The tax laws described above relate to passive losses. Your losses won't be passive if you are a real estate professional. To be treated as a real estate professional, you must spend more than half your working time on real estate—at least 750 hours a year. Then you can deduct any losses from rental property right away, regardless of your AGI.

Limits on Passive Activity Loss Deductions	
Adjusted Gross Income	Maximum Annual Deductions
Up To \$100,000	\$25,000
\$110,000	\$20,000
\$120,000	\$15,000
\$130,000	\$10,000
\$140,000	\$5,000
\$150,000 or More	0

Source: www.webtax.com

## Tax Calendar

### FEBRUARY 2008

**February 11**

**Employees who work for tips.** If you received \$20 or more in tips during January, report them to your employer. You can use Form 4070.

**February 15**

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in January if the monthly rule applies.

**Individuals.** If you claimed exemption from income tax withholding last year on the Form W-4 you gave your employer, you must file a new Form W-4 to continue your exemption for another year.

**February 16**

**Employers.** Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2007 but did not give you a new Form W-4 to continue the exemption for 2008.

**February 28**

**All businesses.** File information returns (Form 1099) for certain payments you made during 2007. If you file Forms 1099 electronically (not by magnetic media), your due date for filing them with the IRS is March 31.

**February 29**

**Employers.** File Form W-3 along with Copy A of all the Forms W-2 you issued for 2007. If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the Social Security Administration is March 31.

### MARCH 2008

**March 10**

**Employees who work for tips.** If you received \$20 or more in tips during February, report them to your employer. You can use Form 4070.

**March 17**

**Corporations.** File a 2007 calendar year income tax return (Form 1120 or 1120-A) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

**S corporations.** File a 2007 calendar year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

**S corporation election.** File Form 2553, Election by a Small Business Corporation, to choose to be treated as an S corporation beginning with calendar year 2008. If Form 2553 is filed late, S treatment will begin with calendar year 2009.

**Electing large partnerships.** Provide each partner with a copy of Schedule K-1 (Form 1065-B), Partner's Share of Income (Loss) From an Electing Large Partnership, or a substitute Schedule K-1. This due date is effective for the first March 17 following the close of the partnership's tax year. The due date of March 17 applies even if the partnership requests an extension of time to file the Form 1065-B by filing Form 7004.

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in February if the monthly rule applies.

In accordance with IRS Circular 230, this newsletter is not to be considered a "covered opinion" or other written tax advice and should not be relied upon for IRS audit, tax dispute, or any other purpose.

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